

Senator Mike Enzi
Statement On Stock Options
Before the Finance Committee
April 18, 2001

Mr. Chairman, thank you for this opportunity to come before this committee to speak on the subject of executive compensation through stock options. In the wake of the collapse of Enron, I appreciate the concerns members have with the issue of stock options.

As we all know, many of Enron's executives and employees were issued stock options. In the months preceding Enron's bankruptcy, executives who were aware of the true condition which the company was in, exercised millions of dollars of their options. Now, thousands of Enron employees, who were kept in the dark on the company's finances, are left with worthless Enron stock and shattered retirement savings.

I appreciate Members' efforts to try to fix problems posed by Enron. In addition, we shouldn't lump the dot com companies with what happened at Enron. Congress must react to what happened at Enron, but we must be careful not to overreact. While I think legislation may be an appropriate means to ensure employees are protected and prevent future Enrons, we should not do anything to hamper employees from receiving stock in their company. When properly used, stock options can be a marvelous opportunity for employees.

I understand Federal Reserve Chairman Alan Greenspan supports the legislation Senator Levin has put forward because he believes stock options should be treated as compensation. And I agree with him that stock options may, at some point in the future become compensation, but we disagree at when that point is. We must be sure that whatever is done, employees, small businesses, and startup companies are protected. I want those companies to continue to have an incentive to issue options, and employees to have the opportunity to receive them.

Let me explain what as I see as some of the problems with the legislation and what some of the solutions should be. First, it is important to note that the same debate over expensing stock options on company financial statements occurred a few years ago. Some of the same arguments for and against it were debated back then. The solution was to give companies the option of listing the number of stock options issued by a company in a footnote to the financial sheets, or directly on its income or financial statements as an expense. That way investors and employees have the ability to see how much stock was outstanding before they invested in the company or exercised their stock options.

If this legislation was enacted, fewer employees will receive stock options. Instead of employees on all income levels receiving the rewards options offer, only high level executives

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will reap the benefits. Regardless of what Congress does on this issue, these companies are not

going to cease offering CEOs and senior executives this form of compensation. It's just not going to happen. Companies will pay whatever they have to pay in order to get the very best talent at the top levels of the company. If the options become more expensive for the company to offer, which is what the Levin legislation accomplishes, rank-and-file employees will lose an instrumental tool they utilize to develop wealth.

This legislation will also have negative consequences on small businesses and start-up companies. The National Commission on Entrepreneurship has reported "that high-growth entrepreneurial companies create roughly two-thirds of all the new jobs in the United States economy, are responsible for at least two-thirds of the innovation in the economy, and account for about two-thirds of the difference in the economic growth rates among industrialized nations." The Commission has further noted that the Levin/McCain legislation will negatively affect "the 30 years of favorable tax and accounting treatment afforded the stock options granted by entrepreneurial companies to their employees."

These small start-up companies cannot afford to offer the salaries larger companies give, so they must offer stock options as an incentive to attract highly-skilled employees. The Commission points out that without stock options household names like Intel, Federal Express, Apple, Dell and Starbuck, would not exist. And under the current law, the employees that take the risk of working for start-up companies have the ability to make much more money than through the traditional method of payment by wages. Again, most employees do not want to lose this monetary opportunity, and start-up companies certainly cannot risk losing the stock option incentive they currently have to attract employees.

We all know that ingenuity and the entrepreneurial spirit have helped make this country great. Small companies and startup businesses have been the backbone of our economy. They have provided economic growth and employment opportunities to small and medium sized communities. We cannot risk discouraging this important trend by placing negative pressure on this already fragile sector of the economy.

Another concern I have with the Levin legislation is that it is so difficult to value stocks at the time options are granted. It is difficult and unfair to require companies to value stock options as an expense for their financial statements when the value cannot be accurately estimated. For instance, many options which were granted over the past several years are now valueless. What's even more distressing is that many of these stock prices will never rise back to the levels they once were. In fact, many of the companies from the Internet boom that offered large options packages are now either delisted or bankrupt. It would have been impossible to properly expense these now worthless options.

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Let me also talk briefly about how the current tax law works. Right now, when stock options are granted or issued there is no tax consequence for either the employer or employee.

But when the stock options are exercised, the employee is taxed as if it is ordinary income. The amount is based on the difference between the market price and the exercise price. At the time these stock options are exercised, the employer can then take a deduction in an amount equal to what is considered as ordinary income to the employee. This deduction provides a useful tool for a company to offer options to its employees. Unfortunately, under the Levin law, companies will be forced to list the numbers of stock options issued as an expense on its financial statement before they can take the current tax deduction.

I believe the footnote on issuance of stock options provides sufficient information to investors and employees. Critics who claim this is insufficient underestimate the sophistication of the investing community. Institutional investors and research analysts are able to accurately account the affect the footnote would have on the balance sheet. With this information, average investors can then make educated decisions as to whether to invest in a specific company.

I know issues need to be addressed to reassure the public no future corporate financial catastrophes will occur. However, the problems with these companies won't be fixed with a slight of hand in changing the way in which stock options are expensed or reported. We all know these problems run deeper than that.

What we do need is fuller disclosure and more transparent financial reports. We must require better quality control and enforcement mechanisms for the accounting industry. What may also be needed is shareholder approval for certain stock options for corporate executives and sales transactions. I think any legislation on this issue should make certain employees have some input on how stock options are distributed to company employees. We may also want to look at making sure employee stock options are being issued at the current stock price, rather than issuing company executives stock at significantly reduced rates. These are just a few ideas I believe are worth exploring.

I appreciate this Committee's thoroughness in dealing with this issue. It is important that the Senate should not rush into passing legislation as a knee jerk reaction to what happened with Enron. We need to carefully study what the consequences of any legislation will be. We need to listen to all the parties concerned and weigh all the alternatives.

Again, I appreciate being asked here today, and I appreciate the opportunity to offer my view regarding this issue.

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